

BANKRUPTCY—PREFERENTIAL TRANSFERS—PROPERTY OBTAINED UNDER AFTER-ACQUIRED PROPERTY CLAUSE—*Rosenberg v. Rudnick*, 262 F. Supp. 635 (D. Mass. 1967)—The voidable preference problem, which involves a possible conflict between section 60 of the Bankruptcy Act¹ and section 9-108 of the Uniform Commercial Code,² arose in the principal case under the following facts. On April 30, 1962, the defendant, Rudnick, made a loan to Boyle Sundries, Inc. in the amount of 110,000 dollars. A security agreement was executed in connection with the loan, which purported to give the creditor a security interest in the debtor's "equipment, . . . inventory and accounts receivable . . . together with all additions thereto and all property now or hereafter substituted therefore or otherwise acquired in the ordinary course of business."³ A financing statement recording the essentials of this security agreement was properly filed on May 2, 1962. On October 24, 1962, the debtor having failed to pay the debt, the creditor under the security agreement seized the debtor's inventory and sold it. On November 9, 1962, an involuntary petition in bankruptcy was filed against Boyle Sundries, Inc. The trustee in bankruptcy contended the transfers to Rudnick of collateral which the debtor acquired within the four month period preceding bankruptcy were voidable preferences and should be set aside. The court held, however, that for the purpose of determining the date of the alleged preferential transfer, the security interest in the debtor's inventory, which included after-acquired items, was effective as of the date of the agreement's execution and filing. Thus the transfer must be regarded as having taken place on May 2, 1962.⁴

Section 60(a)(1) of the Bankruptcy Act contains the following definition of a preferential transfer:

A preference is a transfer, as defined in this Act,⁵ of any of the property of a debtor to or for the benefit of a creditor for or on

¹ 11 U.S.C. § 96 (1964).

² UNIFORM COMMERCIAL CODE § 9-108 [hereinafter cited as U.C.C.].

³ *Rosenberg v. Rudnick*, 262 F. Supp. 635, 636 (D. Mass. 1967).

⁴ *Id.* at 638.

⁵ Transfer shall include the sale and every other and different mode, direct or indirect, of disposing of or parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor. 11 U.S.C. § 1(30) (1964).

account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.⁶

One of the conditions precedent to a preferential transfer is that the transfer must occur within the four month period preceding bankruptcy. But it appears that the effect of the *Rosenberg* decision is to make rights in the property received by the debtor during the four months preceding bankruptcy unassailable by the trustee in bankruptcy as a voidable transfer. According to the decision, after-acquired collateral is deemed transferred at the time the executed security agreement is properly filed.

Section 60(a)(2) of the Bankruptcy Act states that a transfer of property is deemed made

when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.⁷

This lien creditor test⁸ provided for by the Bankruptcy Act leaves the question of the requisite perfection to state law.⁹ The court in *Rosenberg* recognized that U.C.C. sections 9-303(1)¹⁰ and 9-204(1)¹¹

⁶ 11 U.S.C. § 96(a)(1) (1964).

⁷ 11 U.S.C. § 96(a)(2) (1964).

⁸ Such a lien is defined as one arising in the ordinary course of legal or equitable proceedings upon the entry or docketing of a judgment of decree, or upon an attachment, garnishment, execution, or like process, whether before, upon or after the judgment or decree, or whether before or upon a levy. The lien, then, is the one which a party to a simple contract might secure by a judicial proceeding, either by virtue of a pre-judgment attachment or garnishment, or by virtue of the decree or judgment itself (where state law gives rise to a lien upon the entry of such judgment or decree) or by further process to give effect thereto, as where the lien does not arise until levy of an execution. . . .

W. COLLIER, BANKRUPTCY ACT § 60(a)(4), comment (pamph. ed. 1964); see Comment, *Proposed Amendment to Section Sixty of the Bankruptcy Act*, 57 YALE L.J. 828 (1948).

⁹ See *McKenzie v. Irving Trust Co.*, 323 U.S. 365, 370 (1945); *Corn Exch. Nat'l Bank v. Klauder*, 318 U.S. 434 (1943); *Matthews v. James Talcott, Inc.*, 345 F.2d 374 (7th Cir. 1965).

¹⁰ U.C.C. § 9-303(1) in part says:

A security interest is perfected when it has attached and when all the applicable steps required for perfection have been taken. . . .

¹¹ U.C.C. § 9-204(1) provides:

A security interest cannot attach until there is an agreement (Subsection (3) of

indicate that the items of inventory acquired by Boyle within the four-month period preceding bankruptcy constitute a voidable transfer.¹² These Code sections state that a security interest cannot be perfected until the debtor obtains rights in the collateral. *Rosenberg* suggests, however, that the perfection required by the lien creditor test in the Bankruptcy Act is not the same as the full perfection stipulated in the Code. In other words, section 70(a)(2) of the Bankruptcy Act required the use of state law to determine when the secured creditor has so far perfected his security interest that no subsequent lien creditor can obtain rights superior to his in the collateral.¹³ Thus it makes no difference whether or not the debtor has acquired property rights in the after-acquired property as long as no subsequent lien creditor can obtain rights superior to the creditor.

Therefore, under the Bankruptcy Act it is essential to determine the rights of a subsequent lien creditor under existing state law. Rudnick had an unperfected security interest in the Code sense because, at the time the executed security agreement was filed, the debtor, Boyle, did not have rights in the subsequently-acquired collateral. Section 9-301(1)(a) provides that when a creditor has an unperfected security interest his rights are subordinate to the rights of a person who becomes a lien creditor without knowledge of the creditor's security interest and before perfection under the Code. By filing the security agreement, Rudnick did all that he could do in order to obtain perfection under the Code. The only remaining condition precedent to the Code perfection of his security interest was the obtaining by Boyle of rights in the collateral. However, if the knowledge requirement under section 9-301(1)(a) is *actual* knowledge, Rudnick's security agreement, even though it was properly filed, might be invalid against subsequent lien creditors. If this were the rule, filing would not always be enough to protect creditors in Rudnick's position from an honest mistake as to the

Section 1-201) that it attach and value is given and the debtor has rights in the collateral.

¹² But see Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49, 53-55 (1962).

¹³ *Accord*, *In re Platt*, 257 F. Supp. 478, 481 (E.D. Pa. 1966). *Mattes v. American Acceptance Corp.*, 204 F. Supp. 26 (M.D. Pa. 1961), *aff'd per curiam*, 301 F.2d 908 (3d Cir. 1962), appears to hold that property may be transferred for purposes of § 60 of the Bankruptcy Act even before the debtor receives possession of it. *Contra*, Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518 (1960).

existence of prior creditors. But this interpretation of the knowledge required by U.C.C. section 9-301(1)(a) is at best tenuous; most authorities state that a constructive knowledge standard is required.¹⁴

A justification given by the court to support the result is the entity or floating lien doctrine.¹⁵ Briefly, the entity theory views inventory subject to an after-acquired security interest as a single entity, not as individual items each subject to a separate lien. U.C.C. section 9-205, which validates a floating lien,¹⁶ seems to support this position. But a closer examination of this section shows that while it validates a security interest when the debtor has liberty to dispose of the collateral without being required to account for proceeds of substitute new collateral, section 9-205 does not apply with regard to the *time* of perfection of an agreement containing an after-acquired property clause. Therefore, the entity theory cannot prevail when the Code in no uncertain terms states that a security interest is not perfected until the debtor receives rights in the collateral.¹⁷ *Rosenberg* uses this floating lien concept as an incidental argument and recognizes that it relates more to considerations of policy¹⁸ than to any explicit statutory law.

¹⁴ See Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses Under the Code*, U. PA. L. REV. 194, 215 (1959); Gordon, *supra* note 12, at 66, 67.

¹⁵ Perhaps the most quoted and best enunciated statement of the entity theory was made by Judge Magruder in *Manchester Nat'l Bank v. Roche*, 186 F.2d 827, 831 (1st Cir. 1951):

In other words, the *res* which is the subject of the lien . . . is the merchandise or stock in trade, conceived of as a unit presently and continuously in existence—a "floating mass," the component elements of which may be constantly changing without affecting the identity of the *res*.

However, in conclusion he states that it would be "far-fetched" to read into the New Hampshire Factor's Act any such sophisticated concept. 186 F.2d at 831.

¹⁶ The Code treats the floating lien as a security interest in which the creditor permits the debtor to use, commingle, and dispose of all or part of the collateral . . . with similar articles.

Note, *Uniform Commercial Code—Attempt by Secured Creditor Under Article 9 to Emulate Trustee in Bankruptcy*, 51 KY. L.J. 154, 163 (1962).

¹⁷ King, *Section 9-108 of the Uniform Commercial Code: Does It Insulate the Security Interest from Attack by a Trustee in Bankruptcy?*, 114 U. PA. L. REV. 1117, 1123; 3 W. COLLIER, *BANKRUPTCY* §§ 60.19, 60.59 (14th rev. ed. 1964). But:

Article 9 does not expressly adopt the 'entity' theory as to receivables or as to inventory. On the other hand, it does not reject the theory as to either category, taking no position, expressly or by implication, it leaves the way open . . . for a free case law development.

II G. GILMORE, *SECURITY INTEREST IN PERSONAL PROPERTY* § 45.5 (1965).

¹⁸ In view of the fact that the Uniform Commercial Code has now been

While not sanctioning a transfer in regard to after-acquired collateral as occurring at the time of the filing of the executed security agreement, U.C.C. sections 9-205 and 9-108 taken together in essence provide for an automatic attachment¹⁹ of a floating lien on after-acquired property.²⁰ Professor William E. Hogan discerns this Code-endorsed floating lien as another attempt by the Code:

to improve the position of the secured creditor as against the unsecured creditors and the trustee in bankruptcy The after-acquired property problem, created by the rights-in-the-collateral issue, is an example of a latent provision in the Code inviting secured creditors to gobble up the assets of the debtor prior to the time any unsecured creditor could even begin to take action, at least as to the goods. Coupled together, these various freedoms extended to the secured creditor should induce the courts to read the Code stringently when secured creditors are asserting rights. Otherwise, the unsecured lien creditor and the trustee in bankruptcy will have no assets that can be reached.²¹

By holding that there was no preference within the meaning of section 60 of the Bankruptcy Act, *Rosenberg* avoided grounding its decision on Code section 9-108. This section seems to fly in the face of the Bankruptcy Act, since one of the *sine qua nons* necessary for the existence of a preferential transfer is that it be for an antecedent debt. Under the Code, the security interest in after-acquired collateral is considered to be taken for new value, not as security for an antecedent debt.²² Even if the trustee's contentions

adopted by 48 states, it would seem that the definition of § 9-108 should be regarded as generally accepted and in accord with current business practice and understanding and hence applied in bankruptcy.

Rosenberg v. Rudnick, 262 F. Supp. 635, 639 (D. Mass. 1967). Cf. *Friendly, J.*, in *United States v. Wegematic Corp.*, 360 F.2d 674, 676 (2d Cir. 1966):

We find persuasive the defendant's suggestion of looking to the Uniform Commercial Code as a source for the "federal" law of sales. The Code has been adopted by Congress for the District of Columbia . . . , has been enacted in over forty states, and is thus well on its way to becoming a truly national law of commerce, which . . . is "more complete and more certain, than any other which can conceivably be drawn"

¹⁹ See *Friedman*, *supra* note 14, at 215.

²⁰ In *Benedict v. Ratner*, 268 U.S. 353 (1925), the Court held that there is an inherent fraud in this type of unfettered dominion exercised by the debtor.

²¹ Hogan, *Future Goods, Floating Liens, and Foolish Creditors*, 17 STAN. L. REV. 822, 840 (1965).

²² U.C.C. § 9-108, Comment 1 makes this bold and unprecedented assertion: The determination of when a transfer is for [an] antecedent debt is largely left by the Bankruptcy Act to state law.

See Coogan & Bok, *The Impact of Article 9 of the Uniform Commercial Code on the*

are correct that the transfers were made to Rudnick at the time Boyle obtained rights in the merchandise, a case for a preferential transfer cannot be sustained by the Code because under U.C.C. section 9-108 the after-acquired property is deemed taken for new value, not as payment for an antecedent debt.

In Re Portland Newspaper Publishing Co.,²³ which upholds the decision and rationale of the *Rosenberg* case, appears to perceive U.C.C. section 9-108 as an application of the substituted collateral doctrine.²⁴ Under this doctrine, after-acquired inventory is viewed as a substitute for sold inventory. Since the value of the collateral in the *Portland* case was approximately the same at the time of acquiring the security interest and of filing the petition in bankruptcy, the court reasoned that the creditor was only receiving a substitution of security. Thus no preference was shown to this creditor by the debtor.²⁵ If the value of the collateral decreased instead of remaining the same it would be impossible to apply the substituted collateral theory. When the original collateral gradually left the possession of the owner, it did not generate enough new collateral but resulted in business losses which eventually ended in bankruptcy. The situation in *Portland* is rare. The collateral of the bankrupt usually does not remain the same. Thus in most preferential transfer cases, the substituted collateral theory used in *Portland* would not be applicable.

As the preceding discussion has indicated, the mechanical application of the Bankruptcy Act and the Code in cases involving preferential transfers creates a disharmonious result. Words are an imperfect attempt at manifesting legislative goals. Although the literal meanings of the two statutes may clash as applied to voidable transfers, it is possible that the basic policies underlying the Bankruptcy Act and the Code are the same.²⁶ The presence of U.C.C. section 9-108 is one of the strongest arguments against the

Corporate Indenture, 69 YALE L.J. 203, 244 (1959); Henson, "Proceeds" Under the Uniform Commercial Code, 65 COLUM. L. REV. 232, 236 (1965).

²³ 271 F. Supp. 395 (D. Ore. 1967); see Krause, Kripke and Seligson, *The Code and The Bankruptcy Act: Three Views on Preferences and After-acquired Property*, 42 N.Y.U.L. REV. 278 (1967).

²⁴ Compare 3 W. COLLIER, BANKRUPTCY § 60.21 (14th rev. ed. 1964) with II G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, §§ 45.6, 45.7 (1965).

²⁵ See *In re Pusey Maynes, Breish Co. Herr v. Philadelphia Nat'l Bank*, 122 F.2d 606 (3d Cir. 1941).

²⁶ See Gordon, *supra* note 12, at 57. It is quite possible that § 9-108 of the Code expresses a policy in harmony with the Bankruptcy Act, but the means used to formulate this policy, *i.e.*, the creation of a fictional definition of antecedent debt, is at best inartistic.

Rosenberg and *Portland* positions that the perfection required under the Bankruptcy Act is not the same as that required by the Code. This implies that the drafters of the Code believed that under U.C.C. section 9-204 a security interest in after-acquired property attaching within four months of bankruptcy would be subject to avoidance by the trustee in bankruptcy. However, it is probable that they were trying to obtain a result in accord with the policies of both statutes,²⁷ thereby avoiding confusion and misapplication of the two Acts in voidable preference cases.

Section 60 of the Bankruptcy Act was not intended to void a security interest in after-acquired property received in the ordinary course of business when adequate notice of such an interest has been given. Rather it was intended to insure the uniform treatment of all creditors and to prohibit secret liens and new liens obtained during the four-month period preceding bankruptcy. By filing the security agreement with the Secretary of State and the City Clerk, Rudnick avoided these abuses and achieved the status of a secured creditor. A prospective creditor of Boyle, by checking the public records, would find that Rudnick had a security interest in Boyle's inventory. He would then be on notice to investigate the situation further. It must be recognized that filing is no panacea. Admittedly, filing provides for a definite method of determining the priority of liens, but it is not always commercially expedient for a prospective creditor to check the public records. For example, a large department store extending thousands of charge accounts to its customers does not have time to peruse the public records when it grants credit. Even though the large department store may call the local credit bureau for a credit rating of its customer, is it equitable to charge these large institutions with constructive notice of the public records? If the answer is in the affirmative these businesses will look on this burden as an operating cost and will pass it on to customers. The effect of this will be to make the ordinary customer, who satisfies his financial obligations, pay for the abuses perpetrated by the insolvent debtor.

On the other hand, creditors in the position of the Shawmut Bank, which lent 15,000 dollars to Boyle, extend credit less often than do large department stores, and their loans are substantially higher. Consequently the Shawmut Bank presumably made a thorough check into the credit status of Boyle and discovered the security

²⁷ See *In re Portland Newspaper Publishing Co.*, 271 F. Supp. 395, 399-401 (D. Ore. 1967).

agreement recorded by Rudnick, for Rudnick had endorsed Boyle's note.²⁸ Indeed, the bank would have been exercising something less than due care had it not made a careful examination of the solvency of Boyle when such an amount of money was involved in the transaction. Therefore, it is apparent that a survey showing what type of creditor the trustee in bankruptcy usually represents would be germane to policy considerations in voidable preference cases.

In conclusion, bankruptcy law is uncertain with regard to preferential transfers where after-acquired property is concerned. Although there has not been much litigation in this area, the trend as evidenced by the recent district court decisions in *Rosenberg* and *Portland* gives security agreements covering after-acquired property protection from attack by the trustee in bankruptcy, even when the debtor has obtained rights in the collateral within the four month period preceding bankruptcy. But no court of appeals has yet considered this precise question. The *Rosenberg* case is not being appealed, but it is highly probable that *Portland* will be appealed and it may eventually reach the Supreme Court. Commercial expediency and the free flow of business demand certainty as to the effect of after-acquired property clauses used in security agreements. But in arriving at a result reason and policy should not be sacrificed on the altar of commercial expediency.

CONSTITUTIONAL LAW — FOURTEENTH AMENDMENT — LOSS OF CITIZENSHIP — *Afroyim v. Rusk*, 387 U.S. 253 (1967) — In 1960, Beys Afroyim, a naturalized United States citizen since 1926, attempted to return to this country from Israel, where he had gone in 1950. The United States Department of State refused to renew his passport on the grounds that he had lost his citizenship by voluntary voting in 1951 in an election for the Knesset, the legislative body of Israel. Section 401 (e) of the Nationality Act of 1940,¹ provides that a United States citizen shall lose his citizenship if he votes "in a political election in a foreign state." Afroyim brought a declaratory judgment action against the Secretary of State in federal district court, alleging that section 401 (e) violated both section 1,

²⁸ 262 F. Supp. at 636.

¹ 8 U.S.C. § 1481 (1964). The provisions for loss of citizenship in the Nationality Act of 1940 and the Immigration and Nationality Act of 1952 have been incorporated into subsection (a) 1-10 of § 1481 of the 1958 United States Code.

clause 1, of the fourteenth amendment,² which expressly grants citizenship, and the due process clause of the fifth amendment³ of the United States Constitution. The district court granted summary judgment for defendant,⁴ and the plaintiff appealed. The United States Court of Appeals for the Second Circuit affirmed.⁵ Granting certiorari⁶, the Supreme Court reversed, holding that section 401 (e) of the Nationality Act of 1940 was unconstitutional: Each citizen in this country has a constitutional right to remain a citizen until he voluntarily relinquishes his citizenship, and the federal government cannot take this right away.

In 1957 the Supreme Court upheld the constitutionality of section 401 (e) in *Perez v. Brownell*.⁷ There the Court reasoned that Congress had an implied power to regulate foreign relations which could reasonably be deemed to include the power to deal with American citizens who voted in foreign elections.⁸ This power was found to permit the government to take away United States citizenship as a consequence of such voting. The theory relied upon was that voting by a citizen might cause the foreign country to think the United States desired to interfere in the affairs of the foreign state, or at least the United States approved of the interfering acts⁹ of the citizen. The Court indicated it was the voter's United States citizenship that made the act potentially embarrassing.¹⁰ A "rational nexus" was found to exist between the means used—divestiture of citizenship—and the end sought—avoiding embarrassment in foreign affairs. Termination of citizenship was thus within the implied power of Congress under the necessary and proper clause.¹¹ Other than the cursory statement that possession of citizenship caused the embarrassment, the *Perez* Court did not inquire into the efficacy of divestiture in eliminating friction.

The path chosen by Congress and approved by the Court in

² U.S. Const. amend. XIV, § 1.

³ *Id.* amend. V.

⁴ 250 F. Supp. 686 (S. D. N. Y. 1966).

⁵ 361 F.2d 102 (2d Cir. 1966).

⁶ 385 U.S. 917 (1966).

⁷ *Perez v. Brownell*, 356 U.S. 44 (1958). This opinion was written by Justice Frankfurter and represented a 5-4 decision. The *Afroyim* decision overruling this case was also a 5-4 decision.

⁸ *Id.* at 58-59.

⁹ *Id.*

¹⁰ *Id.* at 60.

¹¹ *Id.*

Perez for avoiding foreign affairs friction is a dubious one. First, the statute, while providing against voting, overlooks other acts of political interference, such as campaigning, speech-making, solicitation and bribery. Furthermore, even if Congress' failure to act against seemingly more abnegating behavior is put aside, one may question the extent to which harm to foreign relations stem from voting. The harshness of characterizing voting as activity inimical to United States foreign policy and to attach to it loss of citizenship was one of Chief Justice Warren's main points of dissent in *Perez*.¹²

But such oversights and imprecisions are without Congress' power unless the statute in question is otherwise unconstitutional. The striking aspect of the *Perez* theory is that the vague language of the necessary and proper clause is invoked with devastating consequences to a citizen. At great expense to the individual, the Act produces a dubious benefit in the way of avoiding international embarrassment. An individual's citizenship is a matter between him and the United States government. There is no assurance that a putatively offended foreign country would be appeased by this nation's declaration that a citizen who voted or did some other specified act is no longer a citizen. The affronted nation may take expatriation as a sign of the United States' good faith and intention not to interfere, or the expatriated citizen may be viewed as a sacrificial lamb, with no diminution in the hostility toward the United States created by the interference. Thus on closer examination the "rational nexus" identified in *Perez* evaporates. The effect of section 401 becomes almost capricious, always extracting a great price from the individual citizen and often in vain. Therefore, it is not surprising that the *Afroyim* Court found itself unable to adhere to the theory advanced in *Perez*.

Instead, the Court took the position that citizenship is a right which cannot be taken away by congressional action, regardless of the possible consequences of a citizen's conduct abroad. The advocates of this position base their argument on the fourteenth amendment and the nature of our government. Justice Black states the fourteenth amendment grants citizenship, and the constitution in no place provides for the withdrawal of citizenship.¹³ Because citizenship is such an important right, the power to withdraw it can-

¹² *Perez v. Brownell*, 356 U.S. 44, 76 (1958) (dissenting opinion).

¹³ *Afroyim v. Rusk*, 387 U.S. 253, 268 (1967).

not be implied,¹⁴ particularly under a government which draws its power to govern from its citizens.¹⁵ Such a power would permit a government to free itself of its obligations to its sovereign—the people—as it saw fit.

Afroyim's theoretical basis takes the case beyond the narrow holding that taking away a person's citizenship for voting in a foreign election is unconstitutional and makes it clear that any statute allowing loss of citizenship as the government's remedy would also be unconstitutional.¹⁶ The implied power theory has been rejected; unless it can be shown that a person has voluntarily relinquished his citizenship, no conduct can result in the loss of it.¹⁷

Congress is now foreclosed from using divestiture of citizenship as a means of furthering foreign policy. But *Afroyim* does not prohibit some means of acting against citizens whose actions give rise to doubts about their status as citizens. The constitutional theory that gained majority support in *Afroyim* does not question the right of a citizen to voluntarily relinquish his citizenship. Chief Justice Warren's dissent in *Perez* recognized that certain acts might indicate a person's intention to give up his citizenship. In recognizing the consequences of such action, the government would not be taking away citizenship in order to implement its general regulatory power, but rather, would be "simply giving formal recognition to the inevitable consequences of the citizen's own voluntary surrender of his citizenship".¹⁸ Justice Black indicated a belief that Congress could give effect to certain voluntary conduct if the question were whether the person had voluntarily relinquished citizenship, rather than whether there was potential harm to the United States in the act. In a concurring opinion in *Nishikawa v. Dulles*, he stated, "of course a citizen has the right to abandon or renounce his citizenship and Congress can enact measures to regulate and affirm such abjuration."¹⁹ What sort of measures are these two members of the current majority alluding to? To the extent that an act such as voting in a political election, taking an oath of al-

¹⁴ *Id.*

¹⁵ In holding that "Government is without power to rob a citizen of his citizenship under § 401 (e)," the opinion went on to say that the fourteenth amendment protects every citizen against a congressionally imposed forcible destruction of his citizenship. *Id.* at 267-68.

¹⁶ *Id.* at 268.

¹⁷ *Id.*

¹⁸ *Perez v. Brownell*, 356 U.S. 44, 68-69 (1958) (dissenting opinion).

¹⁹ *Nishikawa v. Dulles*, 356 U.S. 129, 139 (1958) (concurring opinion).

legiance to a foreign country,²⁰ or serving in the military of a foreign nation²¹ could be said to be inconsistent with the desire to retain United States citizenship, it might be within congressional power to designate these acts as *evidence* of a citizen's desire to give up his citizenship. In the absence of express language by the citizen, certain conduct might still be considered as sufficiently indicative of that citizen's subjective intent, to allow the government to institute a proceeding to objectively determine the effect of that conduct. In such a proceeding, the government might still be able to obtain a decision on the citizenship of an individual who was causing embarrassment in a foreign country. Instead of the government imposing a conclusory presumption of loss of citizenship on certain overt acts, this would allow a determination of a citizen's intention, on the basis of evidentiary conduct.

The specified acts that formerly resulted in automatic loss of citizenship would appear to be the logical starting point for designating conduct that might now be considered only as evidence that a citizen wished to give up his citizenship.²² But any such determination should cover all of the citizen's foreign activity. While it is difficult to assume that the single act of voting in a foreign election constitutes a political attachment to that country inconsistent with continued allegiance to the United States, the act of voting, coupled with other facts could very well indicate a desire to relinquish American citizenship. Even before *Afroyim*, the government was required to prove that the citizen's conduct in the foreign state was the result of free and intelligent choice.²³ *Afroyim* adds the requirement of an intent to renounce citizenship. It seems unlikely that *Afroyim* holds the Constitution is to be satisfied only by a formal renunciation of citizenship by the individual himself. If this were true there

²⁰ See 8 U.S.C. § 1481 (a) (2) (1958); *Kawakita v. United States*, 343 U.S. 717 (1952); *Monaco v. Dulles*, 210 F.2d 760 (2d Cir. 1954).

²¹ See 8 U.S.C. § 1481 (a) (3) (1958); *Marks v. Esperdy*, 377 U.S. 214 (1964) (per curiam), affirming by an equally divided court, *United States ex rel. Marks v. Esperdy*, 315 F.2d 673 (2d Cir. 1963).

²² The Nationality Act of 1940 attached loss of citizenship to (1) naturalization in a foreign state, (2) taking an oath of allegiance to a foreign state, (3) serving in the armed forces of a foreign state, (4) serving in a government position requiring naturalization in the foreign state, or taking an oath of allegiance thereto, (5) voting in a foreign political election, (6) formal renunciation of nationality, (7) deserting the armed forces of this country in time of war, if convicted by a court martial, (8) committing any act of treason against the United States, and (9) departing from or remaining outside this country in time of war for the purpose of evading the draft.

²³ *Nishikawa v. Dulles*, 356 U.S. 129, 133 (1958).

would seem to be no solution to the problem the government claims is caused by foreign political activity of United States citizens. Congress can probably still provide a procedure, conforming with due process, to determine in each case how performance of one or more of these acts illustrates a desire to give up citizenship. It may well be that following *Afroyim* certain conduct can serve as objective evidence of a citizen's desires, in the absence of subjective expression. Before this question is answered, the line must be drawn between voluntary relinquishment of citizenship, and congressionally prescribed conditions for voluntary expatriation.

CORPORATIONS — CONVERTIBLE DEBENTURE HOLDERS LIABILITY UNDER SECURITIES EXCHANGE ACT SECTION 16—*Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967)—Chemical Fund is an open-end diversified investment company, which in 1963 had approximately sixty thousand shareholders and owned securities of sixty-two corporations. It had been a holder of Xerox common stock since 1954, and in December, 1962, Chemical Fund owned 2.36 percent of the outstanding shares. Early in 1961, Xerox made a public offering of 15,072,400 dollars principal amount of convertible subordinated debentures. The debentures, which were protected against dilution and carried no voting rights or participation in the equity of Xerox, were convertible into Xerox common stock. Each one thousand dollar debenture was convertible into approximately 9.5 shares of common stock. In December, 1962, following a program designed to improve the yield from its Xerox investment without sacrificing its ability to take advantage of the rising value of Xerox common stock, Chemical Fund commenced to sell some of its common stock and to purchase Xerox debentures.¹ From December 4 to December 20, 1962, and from April 24 to August 2, 1963, Chemical Fund purchased \$18,000 dollars principal amount of debentures, and sold three thousand shares of common stock. The December 12, 1962, purchase of debentures, together with the debentures previously owned, resulted in the Fund becoming the owner of more than ten percent of the outstanding debentures. It continued to own more than ten percent of the de-

¹ The yield on the debentures was approximately 2.8% of the November 30, 1962, mean market price of \$1,607.50, compared to a yield on the common of .66% of the mean price of \$150.62. *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107, 109 (2d Cir. 1967).

bentures until November 22, 1963, when Xerox called the debentures for redemption.

The Chemical Fund then brought suit for a declaratory judgment that it was not liable for short-swing profits under section 16 of the Securities Exchange Act. Xerox counterclaimed for profits received by the investment company from its transactions. Granting a summary judgment, the United States District Court for the Western District of New York held Chemical Fund liable for a profit of 153,972.43 dollars realized by purchases of debentures and sale of common stock within a six-month period. The United States Court of Appeals for the Second Circuit reversed the decision, holding an investment company owning more than ten percent of a corporation's convertible debentures, which if converted would have enabled the investment company to command only 2.72 percent of the corporation's common stock, was not a "beneficial owner of ten percent of any class of any equity security" within the meaning of the Securities Exchange Act. Therefore, it was not liable for short-swing trading profits.²

The Securities Exchange Act of 1934³ was passed as a result of abuses prevalent in the area of security exchange.⁴ Section 16 of the Securities Exchange Act deals with the abuse of a corporate insider recovering profits from short-swing trading in his own corporate securities.⁵ Its purpose is to deter officers, directors or other

² *Id.* at 107-109.

³ 48 Stat. 881 (1934) [hereinafter cited as Securities Exchange Act], 15 U.S.C. § 78 (1964).

⁴ See Securities Exchange Act § 2, 15 U.S.C. § 78(b) (1959); S. REP. NO. 792, 73d Cong., 2d Sess. 8-9 (1934); B. GRAHAM, D. DODD, & S. COTTLE, *SECURITY ANALYSIS* 679-81 (4th ed. 1962); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385 (1953).

⁵ Securities Exchange Act § 16 (1934). Section 16(a) provides:

Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file . . . the amount of all equity securities of such issuer of which he is the beneficial owner

Section 16(b) provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than exempted security) within any period of less than six-months . . . shall inure to and be recoverable by the issuer, irrespective of any intention

beneficial owners of corporate securities from realizing profit through the use of inside information to which the general stockholding public does not have access.⁶ Thus section 16 imposes a filing requirement on certain beneficial owners and provides that such owners shall be liable to the corporation for profits made from buying and selling its equity securities within a six-month period. Since its inception, section 16 has been the source of much litigation concerning such aspects of its application as computation of profits,⁷ definition of buying and selling,⁸ and other problems of interpretation.⁹ The *Xerox* case presents the previously undecided issue of what is meant by a "class of equity security" and whether convertible debentures comes within this definition.

Under the Securities Exchange Act, there is no dispute that debentures are considered equity securities.¹⁰ But the debentures are equity securities only because they include the right to acquire shares of Xerox common stock. It is more difficult, however, to show that the debentures are a class of equity security. Nowhere in the Securities Exchange Act is "class" explicitly defined.

*Ellerin v. Massachusetts Mutual Life Insurance Co.*¹¹ was the first case to deal with this point. In *Ellerin* a stockholder brought a

on the part of such beneficial owner, director, or officer . . . of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

⁶ See, S. REP. NO. 1455, 73d Cong., 2d Sess. 55 (1934); *Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Cong. 2d Sess. 6423, 6430 (1934); B. GRAHAM, D. DODD & C. COTTLE, *SECURITY ANALYSIS* 679-81 (4th ed. 1962); L. LOSS, *SECURITIES REGULATION* 1059 (2d ed. 1961); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385-387 (1953); Yourd, *Trading in Securities by Directors, Officers, and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 134 (1939); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1967); Comment, *Insider Trading Without Disclosure—Theory of Liability*, 28 OHIO ST. L.J. 472 (1967). *Contra*, H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

⁷ E.g., *Blau v. Lehman*, 368 U.S. 403 (1962).

⁸ E.g., *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 165 (3d Cir. 1965).

⁹ E.g., *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943).

¹⁰ Securities Exchange Act § 3(a)(10), (11) (1934). Section 3(a)(10) provides: "The term 'security' means any note, stock, treasury stock, bond, debenture . . ." Section 3(a)(11) provides: "The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security . . ."

¹¹ 270 F.2d 259 (2d Cir. 1959).

derivative action on behalf of a corporation against an insurance company dealing in the corporation's stock. The corporation issued two series of cumulative preferred stock, and the question presented was whether an owner of ten percent of one series of stock was a "beneficial owner of ten percent of any class of any equity security." The court held that each issue of the preferred stock was a series of the entire class of cumulative preferred stock.¹² Since preferred stock is considered a "class of any equity security," it would be reasonable to assume that common stock, voting trust certificates, debentures, and other groups of securities with distinct and independent qualities would be considered "classes" under section 16 (b). But the *Xerox* court, which had eight years earlier decided *Ellerin*, dismissed this interpretation of the *Ellerin* decision.¹³ Thus the only prior case which had attempted to define the term "class" was not followed, even though there was no subsequent case law, statutory history, or legislative definition to justify a contrary result. *Xerox* not only failed to distinguish *Ellerin* in a meaningful manner, but the decision did not attempt to refute the strong statutory argument put forward in *Ellerin*, which would have given substantial support to the view that debentures are a class of equity security.¹⁴ The *Xerox* court did not address itself to a strict statutory interpretation, which probably would have led to a contrary holding.¹⁵ Furthermore, the court's cursory discussion of *Ellerin* suggests that it bypassed the arguments in favor of a liberal interpretation of section 16, reflecting their view of the congressional purpose behind it. By recognizing that this was the approach taken, *Xerox* can be reconciled with *Ellerin* and the statute.

Previous cases have noted that interpretation of section 16 is

¹² *Id.*

¹³ 377 F.2d 107, 111 (2d Cir. 1967).

¹⁴ The argument is based on the words in 16 (a): "any class of any equity security which is registered pursuant to section 12 [on a national securities exchange] . . .," which are then supposed to bring into play 17 C.F.R. §§ 240.12d1-1(a), 240.12d1-1(d). These sections explain the registration procedures, and they imply that any type of security of an issuer which is registered on a national security exchange is a "class of any equity security." *Ellerin* held that these statutes do not apply to separate "series" of one class of stock, but that they apply to the whole class of securities of which the series are the parts. 270 F.2d 259, 264-65 (2d Cir. 1959).

¹⁵ The briefs for both Chemical Fund and *Xerox* reflect that both parties felt the case would turn on whether the transactions involved were exempted arbitrage transactions, and not on whether the debentures were considered a "class." Brief for Appellant 19-42, Brief for Appellee 16-42, *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967).

not a matter of arbitrary application. The interpretation and application of the section should be consistent with its general aims. In a recent decision a purely semantic argument for the application of section 16 (b) was rejected by the court:

[T]he inquiry whether a certain transaction lends itself to the accomplishment of what section 16 (b) is designed to prevent must be decided 'by the minds of the finders of fact.' This is true of the task of law application generally. There is no rule so 'objective' ("automatic" would be a better word) that it does not require some mental effort in applying it on the part of the person or persons entrusted by law with its application.¹⁶

Section 16 (a) provides that any person "who is a beneficial owner of more than 10 per centum of any equity security, must register his securities" The preamble to section 16 (b) states that its purpose is to prevent the unfair use of information which may have been obtained by such beneficial owner by reason of his relationship to the issuer. Thus to conclude that debentures were not a class which Congress intended to include, it must be determined whether the Chemical Fund's "relationship to the issuer," Xerox, was or could have been the type of relationship intended to be subject to the sanctions of section 16.¹⁷

Directors or officers of a corporation are subject to section 16, for through their positions they have access to inside information not available to the market generally.¹⁸ Congress also concluded that ownership of ten percent of a class of equity security is relevant to whether the security owner's relationship to the issuer is such that he might have access to inside information or have the potential of

¹⁶ *Blau v. Lamb*, 363 F.2d 507, 520 (2d Cir. 1966); *see*, *Ferrailo v. Newman*, 259 F.2d 342, 344 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959), in which Stewart, j. stated:

It is also apparent, however, that the question is not in any event primarily a semantic one, but must be resolved in the light of the legislative purpose—to curb short swing speculation by insiders. . . . A series of decisions . . . have marked out an approach to the problem which is pragmatic rather than technical. Each case has been decided on its own facts, and the enunciation of a 'black letter rubric' has been expressly avoided.

See *Blau v. Max Factor & Co.*, 342 F.2d 304, 307 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965); *Roberts v. Eaton*, 212 F.2d 82, 85 (2d Cir. 1954), *cert. denied*, 348 U.S. 827 (1954). *Contra*, *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 165 (3d Cir. 1965).

¹⁷ Brief for Plaintiff-Appellant at 20, *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967).

¹⁸ *See* Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939). *See also* authorities cited *supra* note 4.

corporate control. The legislative history of the Securities Exchange Act demonstrates Congress believed that ten percent ownership¹⁹ of equity securities might lead to this result.²⁰ Since Congress has deemed ten percent ownership as the point at which inside information may be accessible, it is not difficult to see why a holder of ten percent of a corporation's issue of common stock, which usually carries with it specific voting rights, may have access to inside information "by reason of his relationship to the issuer." Nor is it difficult to see why an owner of ten percent or more of the outstanding preferred stock, which may have special voting rights attached with it, should be liable for shortswing profits under section 16(b). An owner having ten percent of the voting stock of a company, although not in full control of the corporation, is likely to be in a close relationship to the issuer because his votes usually elect directors or control certain aspects of corporate policy.²¹

But does such a relationship to the issuer develop when a stockholder owns ten percent of a corporation's convertible debentures, especially when the debentures gives the owner only the position of a debt holder entitled to certain specific payments of interest at stated intervals?²² The type of debenture held by Chemical Fund had no special or general voting power attached to it, nor did it have any other characteristic which might permit a debenture holder to make use of or to have access to inside information.²³ The

¹⁹ The House Bill as originally drafted chose 5% as the figure at which control was possible. This was changed to 10% however, in the final draft. 78 CONG. REC. 73d Cong. 2d Sess. 807 (1934).

²⁰ The original House Bill was supported by its sponsor who said in part:

Mr. Lea of California. I recognize that the 5 percent line is an arbitrary one. It is variable in its effects in reference to different corporations. As to all corporations listed on the great exchanges of the country, 5 percent represents an important part of the stock of such corporations. It is so commonly the case that a man who owns a large amount of stock, but nothing like a majority, controls the directors of the corporation that the committee thought it was advisable to require these large stockholders who may be trafficking in the stock of the corporation to reveal the facts. 78 Cong. Rec., 73d Cong., 2d Sess. 8037 (1934).

See, *Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6556, 7742 (1934).

²¹ 377 F.2d 107, 110-11 (2d Cir. 1967); see note 20 *supra*.

²² 377 F.2d 107, 111 (2d Cir. 1967).

²³ The motive or intent of the insider is immaterial in determining whether or not he is liable for short swing profits. Liability attaches even without speculative intent. Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1964); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959); *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d

debenture is an equity security because of the conversion rights attached to it.²⁴ To hold the owner liable would produce the inequitable situation pointed out by the *Xerox* court. That is, the Chemical Fund would be liable under section 16(b) because it owned ten percent of the convertible debentures, even though on conversion they would control only 2.72 percent of Xerox common stock, while on the other hand a person owning 9.5 percent of Xerox common stock would not be considered an insider.²⁵

Because of the policy behind section 16 and the inequities that would follow a contrary holding, the *Xerox* court has rejected a strict construction of section 16(b) and has based its opinion on the underlying congressional purpose. The court held that convertible debentures are not, by themselves, a "class of any equity security." Instead, the total percentage of common stock which a holder would own on a hypothetical conversion of his debentures is the actual test of liability.²⁶ The class in other words, is not the debentures themselves; the class must be determined by the amount of securities acquirable on conversion.²⁷

Although the decision is an equitable interpretation of the statute, the problem still remains that the statute itself implies a contrary result. It is foreseeable, therefore, that a subsequent case may be decided on a strict reading of the statute and a different result may be reached.²⁸ In cases concerning securities such as con-

Cir. 1956), *cert. denied*, 352 U.S. 831 (1956); *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958).

²⁴ Securities Exchange Act, *supra* note 10.

²⁵ *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107, 111 (2d Cir. 1967).

²⁶ *Id.*

²⁷ The *Xerox* case seems to be implying that the requisite 10% ownership "of any equity security" is calculated by the amount of common stock outstanding plus the amount of common stock obtained by the conversion of the debentures of the alleged 10% holder. But the court leaves unresolved the time at which such a calculation is to be made; a factor which may have a great effect in determining whether a debenture owner actually owns 10% of the underlying securities. In a situation similar to *Xerox*, when it is more lucrative for a debenture holder to convert his holdings into common stock than to allow a company to redeem, it is inevitable that a mass conversion by debentures holders will take place. Thus, in a very short period, the number of shares of common stock outstanding may be greatly increased. Should the requisite 10% ownership be calculated on the amount of common stock outstanding before the mass conversion, after the mass conversion, or at the exact time when a conversion is made by an alleged 10% holder?

²⁸ See *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 165 (3rd Cir. 1965). This recent case expressed the view that the test of liability under section 16(b) is entirely "objective." It may be questioned whether or not *Xerox* would have been decided the same under this interpretation of the statute.

vertible preferred stock, warrants, and voting trust certificates,²⁹ courts following *Xerox* will be required to determine in each case whether the rights attached to the convertible securities before conversion would create the situation of the owner becoming an insider. If such a relationship cannot be established because of the particular security involved, then the *Xerox* test of considering the amount of underlying conversion security as the test for liability would apply.

²⁹ Although *Xerox* held that debentures are not a class of any equity security in themselves, the court states that the position of the Security Exchange Commission in their *amicus curiae* brief may be tenable with respect to holding voting trust certificates as a class of equity security. Though there are some basic similarities between convertible debentures and voting trust certificates there are also some substantial reasons for recognizing a different application of § 16(b) liability as to the two classes. 17 C.F.R. § 240.16a-2 states that percentage ownership of the class of voting trust certificates shall be "deemed to consist of the amount of voting trust certificates . . . issuable with respect to the total amount of outstanding equity securities of the class which may be deposited under the voting trust agreement . . . whether or not all of such outstanding securities have been so deposited . . ." Thus an owner of 10% of the securities in a closed voting trust limited to 20% of the outstanding common stock is liable under 16(b). Although he owns only 2% of the common stock of the corporation, he may control a 20% block of votes deposited in the voting trust, and therefore he could possibly be in a "close relationship to the issuer." But, assume that there is an open voting trust formed with 100% of the common stock being the upper limit of the trust. If 50% of the common stock was deposited in the trust, a person owning 5% of the stock so deposited would own 10% of the voting trust. Such an owner may in effect control the whole voting trust and have access to "inside information" due to his strong position. He would not be liable, however, under 16(b) for he does not own 10% of the class of common stock. He also does not own 10% of the voting trust, for under 17 C.F.R. 240.16a-2 he does not own 10% of *all* the stock which *may* be deposited under the trust agreement. In this situation and until more stock is deposited in the trust, such an owner may have access to inside "information" due to his strong position, but would escape the liability imposed by § 16(b).

